

Growth Potential: Tier II and Tier III Cities in India



This Chillibreeze publication is based on various reports and surveys about tier II and III Indian cities.

This document lists the top tier II and III cities, their business potential and touches upon corporate plans, government initiatives and infrastructure concerns.

We hope readers will find it useful.

In case of any suggestions, enquiries or feedback, please mail epublishing@chillibreeze.com

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India is going full steam ahead with its FDI and overseas acquisitions. FDI inflows from April 2007 to February 2008 were a whopping US\$ 20.14 billion, up 70% from the previous year.¹ India Inc. struck deals worth over US\$ 40 billion on global M&As in addition to US\$ 10.84 billion on domestic acquisitions.² The GDP growth rate has slowed down in 2008, but continued to hover around 8% in the first quarter. And then there is the much-written about middle class, relatively younger and English speaking population that is the focus of most India-related business strategies for a number of firms across sectors. All these factors point to development, and a scaling up of quality of life. What makes the picture near perfect is the likelihood that this growth is going to be more evenly spread than ever before, and will certainly not be concentrated and restricted to the tier I or the metro cities.

If the media focus is anything to go by, most of the development is expected in the tier II and III cities, which is really where the teeming Indian middle class lives. Be it in terms of education – several are home to some good quality universities that produce the thousands of graduates and engineers; or in terms of employment – with outsourcing, IT and retail gunning for these smaller cities in search of space or customers or employees or all of the above.

Just what kind of development can these cities expect to see? Who is going there and why? How will this impact the regular guy on the street? Is there really some potential in these cities? Surely there must be some challenges? This report aims to answer these questions and much more. So buckle up and get ready to take off on a trip to the “real” India.

The recent economic slowdown due to global recession has affected market sentiment in India too. This has led to slower than estimated growth in smaller towns. However, the potential they display will continue to hold in the long run.

¹ Record FDI inflows into India, Asia Economy Watch, <http://www.asiaeconomywatch.co.uk/2008/04/07/record-fdi-inflows-into-india/>

² India's global M&A boom, BusinessWeek, http://www.businessweek.com/globalbiz/content/may2008/gb20080515_348771.htm

Interestingly, the tiers or classification differs sector to sector. There is one classification of Indian cities into A (including A1, A2 and so on), B, C and D based on HRA (house rent allowance) and CCA (city compensatory allowance), which essentially classifies these cities based on cost of living. IMA, a firm servicing the IT and outsourcing sector, segregates cities in tiers to differentiate between major IT centres followed by the “second rung” and the “third rung” cities. Players in real estate development classify them based on the stage of real estate development these cities are witnessing. We find that there are significant overlaps; with real estate development catching up as IT firms or retail majors show an interest in these cities.

Table I: Classification of Cities based on Real Estate Market

	Cities	Characteristics
Tier I	Bangalore, Mumbai, NCR	Fairly well-established real estate market. Demand drivers quite pronounced
Tier II	Hyderabad, Chennai, Pune, Kolkata	Growing real estate markets. Experiencing heightened demand and investments
Tier III	Chandigarh, Ludhiana, Lucknow, Guwahati, Bhubaneswar, Jaipur, Ahmedabad, Surat, Nagpur, Indore, Goa, Visakapatnam, Mysore, Coimbatore, Kochi, Vijaywada, Mangalore, Trivandrum and Baroda	Real estate markets yet to establish. Perceived to have substantial potential demand

Source: *innews.com*

Tier II and Tier III cities are appearing as highly attractive destinations to a variety of businesses – retail, outsourcing, IT and real estate investments and development. This sentiment has taken a beating in the last couple of months due to the downswing in the stock market and an overall weakening of the economy. The global economic gloom has had a ripple effect, and this has resulted in reduced interest in smaller cities. According to some reports, interest in tier II and tier III cities will revive once the economy swings up. They also indicate that a natural correction in real estate prices was in order in some overheated pockets of the country.³

Share of retail in India's GDP is set to touch 22% in 2010.

- A. T. Kearney's 2008 Global Retail Development Index (GRDI) ranked India second, after Vietnam, as the most attractive emerging market destination for retailers. According to an ASSO-CHAM study, the retail market is set to touch US\$ 365 billion in 2008, as opposed to US\$ 300 million in 2007. A report by Images Retail estimates the number of operational malls to cross 412 by 2010, with significant retail activity in tier II and tier III cities.⁴
 - India's IT-ITeS sector grew by 33% in 2008, with revenues of US\$64 billion. Of this, the BPO sector grew by 31%, contributing US\$12.5 billion to the aggregate revenue.⁵ The ITeS sector, facing thinning cost arbitrage due to a stronger rupee, in addition to other challenges like rising costs and capacity constraints, continues to expand to tier II and III cities like Chennai, Hyderabad, Pune, Jaipur, Chandigarh, Ahmedabad and Mysore. A study by Everest and NASSCOM titled Roadmap 2012 indicates that the BPO sector has the potential to achieve revenues of US\$50 billion, providing employment to 2 million people and spurring growth in tier II and tier III cities.⁶
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- Gartner India and several other research firms have predicted that India is likely to lose some of its significant market share in the offshore BPO business – a drop fuelled by rising labour costs and shortage of skilled labour. Industry analysts point out that the concentration of BPOs in pockets like Bangalore, Gurgaon and Mumbai has meant that they target the same talent pool, pushing up demand. The most apparent solution is to seek (greener?) pastures in tier II and III cities.
 - Overseas real estate investors are now looking at India with renewed interest following the partial relaxation of FDI rules. A report (part of the "World Winning Cities" Series) by real estate consultants Jones Lang LaSalle also highlights India as an attractive investment option, with the most benefit likely to accrue to those investors with "long term strategic vision and a commitment to India". The report is bullish on tier II cities like Chennai, Hyderabad and Pune.

³ Now realty gloom trickles down to smaller cities, Economic Times,

http://economictimes.indiatimes.com/News_by_Industry/Realty_gloom_trickles_to_small_cities/articleshow/3718154.cms

⁴ Retail, <http://www.ibef.org/industry/retail.aspx>

⁵ IT enabled Services, <http://www.ibef.org/industry/ITenabledservices.aspx>

⁶ IT enabled Services, <http://www.ibef.org/industry/ITenabledservices.aspx>